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NATO PLEASE PASS TO LT. GENERAL HANLON

E.O. 12958: N/A

TAGS: [OREP](#) [PREL](#) [PGOV](#) [MARR](#) [HR](#)

SUBJECT: Croatia Scene Setter for Lt. General Hanlon

¶1. SUMMARY: The last few months have brought a string of good news for Croatia and the government of Prime Minister Ivo Sanader. With EU accession negotiations opened on October 4 and fugitive general Ante Gotovina arrested in Spain on December 7, Croatia has now cleared the major political obstacles in its path to Euro-Atlantic integration. What remains are the more difficult agendas of defense and economic reform. As a candidate for NATO membership, Croatia now needs to make serious progress in the area of defense reform and demonstrate that it can become a net contributor to the Alliance's new missions. On the economic front, Croatia has made steady, albeit uneven progress in enacting the reforms necessary for it to keep pace with its more advanced northern neighbors. Ten years after the end of the war, Croatia still lags in attracting vital foreign investment because of an ineffective legal system, rigid socialist-legacy labor laws and bureaucratic inertia. Our goal is to help quicken the pace of reform and make Croatia a source of stability and economic prosperity in the region. The U.S. fully supports Croatia's aspirations to join NATO and the EU. END SUMMARY.

#### THE NEW FACE OF THE NATIONALIST PARTY

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¶2. Croatia's current government is led by the Croatian Democratic Union (HDZ) party of PM Ivo Sanader, elected in November 2003 on a platform promising to bring Croatia into the EU and NATO. The HDZ has proven it is no longer cut from the same cloth as the nationalist HDZ of the late president Franjo Tudjman in the 1990s. PM Sanader made important gestures immediately after taking office, such as visiting the Serb Community on Orthodox Christmas, reaching out to the Muslim minority, and signing coalition agreements with the Serb parliamentary grouping -- things almost unthinkable just months before. In addition, he has made great strides in normalizing relations with Serbia and Montenegro and Bosnia and Herzegovina, including high-level visits, visa-free travel and free trade agreements.

¶3. The opening of EU accession negotiations on October 4, 2005 was a major victory for the Sanader government. Croatia cleared a further hurdle on December 7, when fugitive general Ante Gotovina was arrested in Spain and transferred to the ICTY in The Hague to stand trial for charges of war crimes committed in the aftermath of Croatia's Operation Storm, which liberated the Serb-occupied Krajina region in 1995. The Gotovina arrest, applauded by the U.S. and the international community, was generally unpopular domestically, as many Croats consider Gotovina a hero of their war of independence. However, it appears unlikely that this arrest will inflict lasting political damage on Sanader, as it was largely expected after Gotovina's four years on the run. Protests, which died down

after only a few days, were peaceful and generally smaller than expected.

#### EURO-ATLANTIC INTEGRATION: NOT IF, BUT WHEN

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¶4. Croatia is making progress in its stated goal of NATO membership, particularly with Gotovina now in The Hague. There is a general consensus among the political elite that Croatia belongs in NATO, but this is not matched by similar levels of support among the general public. Over the summer, the parliament approved tripling to 150 Croatia's troop (currently primarily Military Police) contribution to NATO's ISAF mission in Afghanistan. A Croatian MP platoon is currently in its sixth rotation in Kabul and the first increase in ISAF contributions will be a demining unit to deploy with the Lithuanian PRT in Chagcharan. Currently, Croatia has 30 persons deployed on 10 UN peace support operations, including Major General Dragutin Repinc, who assumed command on December 29 of the UNMOGIP operation in Kashmir.

¶5. Croatia has an ambitious military reform program in place to make the armed forces "NATO-ready" by 2007 - a difficult task under the best circumstances. The government signed off earlier this year on the Strategic Defense Review, which bases future defense planning on the assumption that Croatia has no serious threats to its territorial integrity and will be a full partner in collective defense through NATO. The Long Term Development Plan for the Croatian Armed Forces, currently in semi-final draft form, attempts to bridge the gap between the defense reform vision of the SDR and the likely fiscal shortfalls over the next three-five years. Defense spending is currently just short of the Prague Capabilities Commitment level of 2 percent of GDP, although massive pension payments to war veterans and a personnel-heavy defense budget leave only minimal resources for much-needed equipment procurement. U.S. firms, including Lockheed-Martin, ITT and Motorola are supplying equipment to the Croatian military and General Dynamics and Raytheon are currently bidding on contracts for the major, upcoming purchase of armored personnel carriers. We support Croatia's NATO ambitions, but have been very clear in our message that defense reform is an essential pre-condition for Croatia to demonstrate that it will become a net contributor to security through NATO operations.

#### THE WAR IS OVER, BUT THE SCARS REMAIN

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¶6. Among the more important accomplishments of PM Sanader's government are advances in addressing the legacy of the 1991-95 war. In addition to improvements in cooperation with the ICTY and general adjudication of war crimes, the HDZ government has made significant progress on refugee returns based on its December 2003 coalition agreement with Serb partners. International observers such as the OSCE and UNHCR have praised the government's pace of reconstruction of war-damaged housing and return of refugee property, but believe progress is still needed in the areas of housing for those who lost socialized housing, electrification of reconstructed villages, compensation for looted property, and minority representation in the judiciary, police force, and government administration. Discrimination and resistance to change at the local level are persistent challenges.

¶7. Of the estimated 350,000 people, mostly ethnic Serbs, who were displaced during the war, about 134,000 have returned. This leaves approximately 215,000 refugees and internally-displaced persons derived from the 1991-1995 war - most of these ethnic Serbs now living in Serbia and Montenegro and Bosnia and Herzegovina. A recently completed UNHCR re-registration project clarified the number of true refugees, concluding that approximately half, or 110,000, actually intend to return to Croatia.

¶8. As suggested by the OSCE, UNHCR, and the European

Commission, the Government has created a "road map" with the goal of closing the refugee file in 2006. Elements of this include specific benchmarks such as the resolution of refugee housing, equal access to information and government services, and information on war crimes indictments.

#### ECONOMY: BETTER, BUT MANY TOUGH CHOICES AHEAD

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¶9. Croatia missed out on the initial rush of foreign investment in Central and Eastern Europe following the fall of the Berlin Wall, largely because of the war in the former Yugoslavia, but also because of its slowness to make the difficult but necessary decisions to reform its economy. As such, although its per capita GDP of approximately \$7,800 is over twice that of Serbia and Montenegro, it is only half that of its northern neighbor Slovenia. In recent years, the country has seen general macroeconomic stability, with low inflation and steady growth. Unemployment, however, remains stubbornly high at approximately 14 percent.

¶10. Although there has been progress in shedding some of the state's still large portfolio of assets, notably banks, hotels and large agricultural combines, the government continues to be saddled with loss-making industrial companies whose subsidies drain approximately 3 percent of GDP annually. As a percentage of GDP, the state's role in the economy is far above the EU average at nearly 40 percent. With one pensioner for every 1.4 persons employed, above-average healthcare costs and out of control entitlement programs, the government faces many necessary, but politically unpopular decisions if it is to reduce chronic deficits and liberalize the country's economy.

¶11. Croatia has lagged in attracting foreign direct investment, particularly American investment. This is attributable to several factors, most notably an inefficient judicial system that can take years to resolve even the most basic commercial disputes and a stubbornly Byzantine bureaucracy. We have seen some improvement in this last area, with the government's creation of a "one-stop shop" for business registration and a trade and investment promotion agency to assist prospective foreign investors. We are cautiously optimistic that the government will follow through with promises to build on these initiatives and that judicial reform efforts will bear fruit.

¶12. Croatia's EU neighbors are its largest trading partners and Croatia runs trade deficits with nearly all of them, with imports doubling exports at roughly \$16 billion annually. Trade with the U.S. is relatively small in comparison, approximately \$400 million in 2004, as opposed to \$4.5 billion with Italy and nearly \$2.0 billion with neighboring Slovenia. In a hopeful sign of regional reconciliation, Croatia's trade with both Bosnia and Serbia has shown strong growth this year.

¶13. Croatia's political elite is fully cognizant of the need to reform the economy and has made some recent progress in that direction. However, much more remains to be done if the country is to begin to reach the levels of growth and investment enjoyed by its northern neighbors. Now that Croatia will begin EU accession negotiations, it is possible that EU pressure will provide the government with sufficient political cover to tackle some of these difficult issues.